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Growing out of this banking crisis is harder

Banks are no longer able to benefit from the combination of high inflation and low interest rates in the way they did earlier

SNAKES & LADDERS

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In post-1991 history, we in India have gone through two cycles of boom and bust. The investment boom of 1994 gave way to the woes of the late 1990s, and the investment boom of 2008 gave way to difficulties after 2011. The interesting question is: Why has this downturn proven more difficult to get out of? One element of the explanation is the 4 percentage point decline in inflation.

Let's start at the first boom and bust. Gross fixed assets of private non-financial firms (in the CMIE database) grew by 27.2 per cent in 1994-95. After this, we had six adverse shocks in succession: The Asian currency crisis, the RBI's currency defence of 1998, the nuclear tests, the Y2K bust, the IT bust, and then the 9/11 attacks. It is hard to overstate the gloom that came from these negative blows, coming in one after another. They kicked off a downturn, a banking crisis, and a stock market crisis.

Gross fixed assets growth bottomed out at 7.7 per cent in 2002-03: A decline of about 20 percentage points. India delivered a slew of remarkable reforms when faced with that stress in the economy and conditions changed.

And then, we got the second boom and bust. In this boom, gross fixed assets growth peaked again in 2008-09 at 26.7 per cent and then went into a long decline. We have got values of 6.7 per cent in 2015-16, followed by 7.2 per cent in 2016-17. Once again, we got a decline of about 20 percentage points.

This story of two busts frames the story of two banking crises. In the 1999-2003 period, half the bank credit in the CMIE database sat in firms at high levels of credit stress, i.e. an interest cover ratio of worse than 1.5 for at least two consecutive years. At the peak of the business cycle, only 15 per cent of bank credit was in stressed firms. In the second decline, things are a bit worse: About 60 per cent of bank credit is now in stressed firms.

History does not repeat itself, but it sometimes rhymes. It is very valuable to look back at the two experiences and wonder how we might get out of our difficult spot today. There was one factor in the first period, which strongly favoured banks at the expense of their customers, which is now less present. This has to do with inflation.

Earlier, CPI inflation averaged 8 per cent. The RBI had no objective, and was relaxed in responding to inflation. For the first time in its history, the RBI got an objective, on February 20, 2015, of 4 per cent CPI inflation, with the signing of the Monetary Policy Framework Agreement. The inflation target was later placed in the RBI Act.

When households placed money into savings bank accounts at about 3 per cent, and inflation was 8 per cent, they earned about -5 per cent real returns. When firms held current accounts at 0 per ce they earned about -8 per cent real returns on th deposits. This arrangement constituted a powe subsidy in favour of banks.

A related issue concerns sheer nominal grov In the old days, we had 8 per cent inflation and h GDP growth. Bank balance sheets doubled ev four years. Bad assets could be hidden for a wh and the sheer growth of the balance sheet made bad assets seem less frightening when the truth revealed. The culture of hiding bad news entrenched in banks and the RBI.

Both these factors played in favour of banks fa with bad assets. They had to just hang in there. Ev year, their profits were augmented through calla deposits that were given to them at about -6 per c real. Every year, their balance sheet grew shar Within a few years, a bad banking crisis tended look more manageable.

These things have changed. Now, CPI inflatio about 4 per cent. Households still earn about 3 cent in savings bank accounts, and their real retur about -1 per cent. This is a difference of 4 percent points in favour of households and against banks wi we compare the 1991-2015 experience versus the p 2015 period. Similarly, firms still get 0 per cent for c rent accounts, and this translates into -4 per cent r This is four percentage points inferior, from the vi point of banks, when compared with the old days.

Banks are still unfair to callable deposits — w negative real rates of return. But the extent to wh banks earn an unfair profit by merely existing a holding deposits has gone down.

Similarly, the sheer growth of bank balance she has slowed. The inflation rate has dropped from 8 cent to 4 per cent, and overall growth has slow Households have more choices, and that may m them less willing to keep money with banks at n ative real rates. Electronic payment systems n imply that firms need smaller buffers in their curr accounts. All these factors mean that bank bala sheets now grow slowly.

These factors help us understand why the seco banking crisis seems harder than the previous o even though we have the new IBC (Insolvency a Bankruptcy Code) weapon. High inflation, unf ness to customers of banks, and high GDP grov created an environment where it was easier to g out of a banking crisis. We are still unfair to c tomers of banks, but the macroeconomic envir ment has changed. The inflation rate is lower b percentage points and nominal GDP growth is l er by more than 4 percentage points. The subsid banks from callable deposits has declined, and harder to merely let time and balance sheet grov address a banking crisis.

The one thing that has changed in the seco bust, when compared with the first one, is the I The IBC holds the possibility of taking an asset Bhushan Steel, which was producing 3 mill tonnes of steel per year, and swiftly convertin into an asset that produces 5 million tonnes of s per year, under the new ownership. This trans mative tool was absent in the first bust. We need dig in on the execution of the IBC, so as to scale from a few large transactions per year to a few la transactions per month.

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